Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers	)	

REPLY COMMENTS OF
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Time Warner Communications ("Time Warner") respectfully submits these reply comments in the Commission's price cap performance review for local exchange carriers.

I. Introduction

In its initial comments, Time Warner focused its attention on the relationship between the goals of price cap regulation and the Commission's ultimate objective of fostering, and eventually attaining, effective competition for local exchange and access services. Those comments voiced a strong concern that premature relaxation of the regulation of LECs in the name of price cap "reform" would create impediments to the eventual realization of effective competition for local exchange and access services. Contrary to the presupposition of certain of the "transition" issues set forth in the Commission's Notice, which suggest a need to anticipate the development of increased competition with "streamlining" of the regulatory process, the development of effective competition for interstate access is not inevitable. Instead, as Time Warner's comments noted, competition must be encouraged by vigorously pursuing various initiatives currently under way, including, for example, the establishment of just and reasonable rates for expanded interconnection, the implementation of number portability, and the important issues under consideration in the Commission's intelligent network proceeding.

Not surprisingly, the LECs have taken full advantage of the Commission's broad-based inquiry to bring forward a very different view of competition in the local exchange and access markets, and to call for what amounts to a substantial measure of deregulation. The LECs' objective is clear: they are determined to attain the maximum revenue production and the greatest pricing flexibility, *all before* competition has had the opportunity to take hold to any meaningful extent. In their comments, the LECs clearly show how the interests of their shareholders and interested observers in the financial industry would be served by their proposals. What they have utterly failed to show is how the regulatory favors they demand serve the interests of consumers, either in the short run (by assuring reasonable rates) or in the long run (by enabling effective competition to be attained).

The comprehensive transformation of the price cap regime envisioned by the LECs is wholly self-serving and does violence to the Communications Act, to the Commission's original and still legitimate objectives for the LEC price cap plan, and to the public interest generally. The changes that the LECs portray as necessary improvements to price cap regulation would in fact work against the attainment of the Commission's fundamental policy goals for an efficient, competitive, and innovative telecommunications marketplace:

- *The LECs seek to eliminate competitors as soon as they emerge by responding with selective, targeted price reductions, the financial impact of which can be readily offset through higher rates to be imposed in non-competitive areas.* Contrary to what is being asserted by the LECs, the detailed USTA proposal for market-based regulation, and other mechanisms for achieving extensive pricing flexibility (e.g., changes to the price cap baskets, Part 69 and new services rules, individual case basis contracts) are not required in order for the LECs to "respond" to competition. In fact, rather than permitting a "response" to competition once it has been established as a consequential market attribute, the LECs' proposals would actually allow them to zero in on nascent entrants and then to snuff out such competition almost as soon as its presence becomes visible through a microscope, long before it is apparent to the naked eye. Acceptance of the LECs' flexibility agenda would serve to chill non-LEC interest in acquiring the very resources that could, one day, compete effectively with the LECs' established networks.

- *The LECs seek to accomplish the premature dismantling of effective price cap regulation.* Under the rubric of the USTA proposal, the LECs would accomplish deregulation on a piecemeal basis, by imagining markets to be competitive based upon mere perception and potential, and not upon any reality. USTA and the LECs ignore or dismiss long-standing and well-accepted tests for the presence of effective competition, substituting for them a "mere existence" standard as a rationale for the virtual elimination of regulatory safeguards and constraints.

- *The LECs seek the opportunity to maximize profits without regard to the interests of consumers and at the expense of the Commission's pro-competitive policies.* If the USTA wish list for price cap changes is adopted, the "just and reasonable rates" principles established in the Communications Act would be replaced by almost unlimited, unconstrained earnings potential. Indeed, all elements of the price cap plan that bear upon earnings (particularly earnings sharing and depreciation controls) would be discarded. It cannot be disputed that LECs and LEC investors would prefer to retain all excess earnings and to see those earnings escalate to supracompetitive levels (an obvious point that did not require any "studies" by LEC-sponsored "experts"). Yet the utter lack of price-constraining effective competition cannot be relied upon, as the LECs claim, to substitute for effective regulation in assuring efficient transfer of LEC services to consumers and to other sectors of the US economy. *A regulatory "gift" to the LECs in the form of eliminating earnings sharing will be paid for by consumers through higher prices today, and through a failure of* *competition tomorrow.*

- *The excess revenues that will flow to the LECs as a result of their proposed price cap revisions will provide them the opportunity to "gold-plate" and to make inefficient investments in their networks (not justified by any demonstrated demand).* As expressly recognized by the Commission in its LEC Price Cap Order, a specific objective of price cap regulation was to eliminate the so-called "Averch-Johnson" ("A-J") effect under which ROR-regulated utilities were seen as having an incentive to overinvest in their plant.[1] The LECs now argue that their proposed revisions to the Commission's price cap rules are specifically intended to encourage investment which, they argue, would not occur if the existing structure is retained. In just three short years, we seem to have gone "full circle": Price cap regulation is adopted to stimulate efficiency and eliminate excessive investment; now, it is claimed, price caps should be changed to provide incentives for investments that, apparently, cannot withstand economic scrutiny on their own. If this is true, what have we gained by leaving rate of return regulation?

- *By drawing fanciful "comparisons" between themselves and other players who are in no way similarly situated, the LECs seek to avoid meaningful scrutiny of their prices for existing and new services; alternatively, the LECs would have the Commission overburden non-dominant carriers with regulation vastly disproportionate to those*

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[1] Price Cap Performance Review for Local Exchange Carriers, CC Docket 94-1, Notice of Proposed Rulemaking (*NPRM*) at para. 11 (February 16, 1994); Policy and Rules Concerning Rates for Dominant Carriers, CC Docket 87-313, 5 FCC Rcd 6786 at paras. 29-30 (1990) (*LEC Price Cap Order*).

entities' market power. The LECs propose a so-called "pure" price cap regime because AT&T's plan now has this feature, lesser tariff filing requirements such as those which apply to nondominant Competitive Access Providers ("CAPs"), and deregulation "like" that which is applied to cable companies under the Cable Act of 1992 when services become competitive. The LECs are subject to unique regulatory requirements because they maintain a unique hold on the fundamental bottleneck facilities of the local exchange and access services: *LECs are not AT&T*, with its 65% market share;[2] *LECs are not CAPs*, which survive with only a tiny foothold in a small segment of the market and are faced with a myriad of remaining barriers to entry; *LECs are not cable television companies*, whose subscribers confront numerous substitute services, whose present infrastructure is not capable of providing telecommunications services without substantial investment, and whose core business, due to the discretionary nature of its services and the consequent elasticity of demand for those services, cannot be the "cash cow" to cross-subsidize competitive ventures. Adding further regulatory impediments to competitors whose market share is still minute and who continue to face pervasive entry barriers would simply delay the progress of competition.

The dangers inherent in the LECs' bold invitation to dismantle many of the key safeguards of price cap regulation should not be underestimated. While the most immediate and obvious result of excessive pricing flexibility without effective competition is the inability to assure customers of just and reasonable rates, consumers are disadvantaged in a second, and perhaps equally serious, way by the very real threat that such premature

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[2] FCC *Statistics of Communications Common Carriers*, 1992.

relaxation of regulation poses to the prospect of ever realizing the promise of competition in interexchange access and local services.

II. Ineffective Price Cap regulation will frustrate the Commission's broader policy objectives for telecommunications.

A. The Goals of the Price Cap Plan Remain Unchanged

The LECs attempt to convince the Commission that the goals of price caps need to be modified to promote the stimulation of additional capital investment and the deployment of new technologies and services by the LECs.[3] Under the LECs' proposals, this stimulation would be achieved, primarily, by lowering the productivity offset, rescinding the LECs' current obligation to share earnings over benchmark levels, granting them total freedom to set depreciation rates, and adopting the USTA pricing flexibility proposal.[4] Without such additional "carrots," the LECs argue, the national information infrastructure and the economy as a whole will lag far behind their potential.

This view of history, and the future it portends, can only be described as revisionist. The goals that the Commission sought to achieve when it adopted price cap regulation remain valid: "just, reasonable, and nondiscriminatory rates, as well as a communications system that offers innovative, high quality services."[5] In this first review of the effectiveness of price cap regulation of the LECs, it bears remembering that price caps were implemented as an alternative form of economic regulation, not a form of deregulation.[6]

Under revisionist price cap goals promoted by the LECs, the focus is entirely on how

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[3] See, e.g., USTA Comments at 19-21; Bell Atlantic Comments at ii; BellSouth Comments at 6.

[4] See, e.g., USTA Comments at viii-xiii; BellSouth Comments at 7-8.

[5] *LEC Price Cap Order* at para. 2; see also *NPRM* at para. 31.

[6] In the initial comments, this point is aptly made by the Ad Hoc Telecommunications Users Committee (Ad Hoc Committee), which observes that the goal of the price cap regime (as with any form of economic regulation) is to produce a *"competitive result"*. Ad Hoc Committee Comments at 2-4.

to expand LEC investments, LEC-provided services, LEC earnings, etc. Such a view disregards the role of their now-fledgling competitors in making investments, and in developing new technologies and services for the benefit of consumers. Embedding special treatment for LEC investment into the price cap regime would only sustain the LECs' dominance, and would be an additional impediment to the avowed goals of the Commission to promote diverse and competitive telecommunications as the foundation for achieving important national telecommunications policy objectives.

There is irony as well in the assertion that the LEC-proposed modifications to the price cap regime are necessary to encourage continued LEC investment in a declining cost industry. Logically this would imply that it is only through the continued exercise of their existing market power that the LECs can hope to recoup their existing investment in telecommunications infrastructure. To the contrary, the Commission should support the development of a ubiquitous national information infrastructure by continuing to promote the development of competition, rather than by infusing the LECs with vast quantities of ratepayer-supplied funds.

In the same vein, the Commission should be slow to accept the LECs' broad claims for wide-ranging benefits to the economy as a whole of stimulating LEC investment in infrastructure.[7] The Ad Hoc Committee, which conducted an empirical analysis of such claims, found that it is virtually impossible to substantiate a direct and causal link between telecommunications investment and economic growth.[8] Moreover, the Commission should be concerned that whatever investment is artificially stimulated in the dominant providers will

[7] USTA Comments at 96-101 and Attachment 7, The WEFA Group, "The Economic Impact of Revising the Interstate Price Cap Formula for the Local Exchange Companies."

[8] Ad Hoc Committee Comments at 13.

be at the expense of — indeed, will discourage — investment in other, competing providers. The enticing prospect of purported economic benefits of LEC infrastructure investment should not obscure the fact that *alternative investment choices* might be made by consumers or competitors with the same dollars.

The Commission should adopt a broad vision of the future in which all suppliers (the LECs and their competitors) contribute to the development of a national information infrastructure in a way that is efficient and fair. The overriding objective must be, ultimately, to attain competition in the local exchange and access markets. To attain this objective requires (1) moving forward expeditiously to lay the groundwork for competitive provision of access services; and (2) maintaining effective regulation under LEC price caps, to prevent the LECs from using their bottleneck control to impede competitive entry.

B. The Commission must redouble its efforts to remove the barriers to competition, which is, ultimately, the only means of promoting and eventually achieving effective competition for access and local exchange services.

The LECs repeatedly suggest that a more flexible regulatory regime is necessary during the *transition* to a competitive environment. To the contrary, regulatory flexibility should be seen as a *response* to competition, not a *means* to achieving it. MCI wisely cautions that "rather than searching for signs that effective competition exists...the Commission should, instead, focus on modifying regulation to allow the benefits of competition to reach the marketplace."[9] A similar note is struck by ALTS: "Rather than trying to speculate about when the ultimate demise of LEC regulation might become appropriate, the Commission and its state counterparts should concentrate their resources on

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[9] MCI Comments at 72.

removing the significant barriers that still remain. The Commission can help accomplish this by fostering the creation of efficient markets for those services and facilities which are essential to viable competitive entry and open network access, and thereby also facilitate the ultimate development of the 'network of networks.'"[10]

MCI identifies fundamental regulatory initiatives that should be given priority by the Commission in order to manage the transition from monopoly to effective competition, including (1) requiring open and equal access to bottleneck networks; (2) granting co-carrier status to alternative providers (i.e., the same status as incumbent LECs for compensation for terminating traffic, NXX code assignments, interoffice trunking/signalling arrangements, database access arrangements, billing record arrangements, directory listings, access to 911 service, number portability); (3) costing and pricing safeguards to protect against price discrimination, price squeezes, and cross-subsidization; (4) fair, cost-based, competitively neutral application of any requirements regarding alternative provider obligations with regard to universal service subsidies; and (5) adopting regulations on local service providers that are commensurate with their demonstrated level of bottleneck control or market power.[11]

To the initiatives identified by MCI, Time Warner would add its strong recommendation for an expeditious reconsideration of collocation rules in light of the D.C. Circuit's remand[12], as well as Commission affirmance of a right of alternative carriers to interconnect with the LEC networks at points of the alternative carriers' choosing, so as to

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[10] ALTS Comments at 12.

[11] MCI Comments at 73-76. AT&T's Comments also list critical steps for creating the essential conditions under which exchange and access competition can develop. AT&T Comments at 17.

[12] *Bell Atlantic Telephone Companies et al. v. FCC*, D.C. Circuit Nos. 92-1619 et al., Slip. Op., decided June 10, 1994.

be able to design their networks for maximum efficiency. The Commission should make these pro-competitive initiatives the primary focus of its agenda for the next two years, and devote the necessary resources to bring these initiatives to fruition. The ALTS proposal for an ENFIA-like proceeding to bring about hands-on negotiations regarding these important issues, under the supervision of Commission staff, would be an important tool to achieve meaningful progress.[13]

III. The State of Competition Today and for the Foreseeable Future is Not as the LECs Portray It and Requires Continuing, Effective Regulation of the LECs.

Under the view espoused by the LECs, the tail wags the dog: freedom to extract excess revenues from their still largely monopoly businesses and substantial pricing flexibility are demanded *in anticipation of* the development of competition, rather than upon the achievement of competitive markets. The LECs' view of competition varies enormously from the perception of that of nearly every other party to this proceeding: in fact, it is noteworthy that the LECs' sense that widespread competition exists or is imminent is almost universally refuted by their *customers*, from the largest (IXCs and large users) to the smallest (residential customers).[14]

The LECs attempt to convey a sense of urgency to the Commission regarding the changes they demand in the price cap regime, based on the their view of competition. According to the LECs, rapid technological change, customer demand for new technology and related services, and the entry of new service providers are fueling competition at an

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[13] ALTS Comments at 51-53.

[14] See, e.g., Ad Hoc Committee Comments at 32-34; AT&T Comments at 6-8; Pennsylvania Office of Consumer Advocate Comments at 3-4; Ohio Office of Consumers' Counsel at 12-13.

alarming rate.[15] As in prior proceedings, the LECs base their claims with a combination of anecdotal evidence and popular mythology. They spurn such quantitative measures of market power as market share, in favor of theories such as "addressability" (or "contestabilty") that focus on the possibility of competition or the mere presence of competitors.

Because effective competition is such a compelling goal, the prospect of declaring victory (i.e., competition) to be at hand and folding the regulatory tent has a seductive appeal. The Commission must not be seduced. Time Warner again urges the Commission to take a hard look at the reality of current market conditions:

(1) *LEC revenues accounted for in excess of 99% of the relevant local telecommunications market.* Total LEC revenues for all core local telecommunications services were $97.4-billion in 1993,[16] whereas total revenues for all non-LEC providers of local telecommunications services *combined* was only $347-million.[17] Contrary to LEC claims, relative revenues is the most appropriate measure of market share, because revenue weighting reflects the relative *value* of each product line. While the LECs quibble with the exact revenue numbers,[18] they cannot escape from the fact

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[15] See, e.g., USTA Comments at 26-40 and Attachment 2, Robert G. Harris, "Benefits of LEC Price Cap Reform", pp. 9-10; NYNEX Comments at 11-18; BellSouth at 83-92; Bell Atlantic Comments at 4-6.

[16] 10K Annual Reports (for RBHCs), Value Line (for other LECs). Core local telecommunications services consist of residential and business local exchange access line services, carrier access services, local calling, intraLATA long distance calling, and local/intraLATA private line services.

[17] 1993 ALT Report by Connecticut Research.

[18] USTA Att. 9, p. 9.

that whether by revenues, minutes, or any other measure, the LECs' market share is not far from 100%.

(2) *The LECs' virtual monopoly on terminating switched access remains unchallenged by any CAP or other competitor.* Today, and for the foreseeable future, even customers large enough to utilize LEC special access or CAP services for originating access must rely on LEC-provided switched access to terminate their calls.

(3) *Alternative access providers have captured a very small portion of the market.* Aggregate revenues paid by long distance carriers and end users for access services of all CAPs combined are approximately $209 million, or *less than one percent* of the $26 billion LEC access services market.[19] Capital investment for the CAPS as of 1993 was approximately $1-billion as compared with $201-billion in LEC gross plant in service as of 1993.[20] CAP employees number in the vicinity of 3,000, as compared with over 500,000 for the LECs.[21]

(4) *Significant economic, technical, and regulatory barriers face companies seeking to compete with the LECs:* The costs, capacity constraints, quality and reliability of *wireless services* relative to basic local service preclude direct substitution. In addition, the vast majority of cellular calls ultimately involve landline connections, so that cellular is not an alternate to LEC access, but

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[19] Source of CAP data is the 1993 ALT Report by Connecticut Research. Sources of the [redacted]

rather a complement to LEC landline services. *Cable systems* require substantial capital investments to provide two-way telephony. In view of the investments required and the reality of regulatory impediments at the local level, it may be some time before any significant number of consumers would have a competitive alternative available, even under the most favorable scenarios.

(5) *LECs are able to generate substantial cash flow through depreciation charges against regulated telecommunications services.* Extrapolating from recent experience and trends, it is likely that between now and the year 2000, the LECs will generate roughly *$100-billion* in recurring depreciation charges against regulated core telecommunications services, creating cash flow for reinvestment at a level that dwarfs all of the potential competitors combined, and all without risk to LEC shareholders.

In assessing the status of competition, nothing should be more compelling to the Commission than the first-hand experience of the LECs' customers — from the largest, such as the interexchange carriers and large telecommunications users, to the smallest, residential customers, represented by state consumer advocates. Who is in a better position to know whether there are real competitive choices? For example, MCI states, "Contrary to the claims of the LECs that they face robust competition in many of their markets today, MCI's experience in purchasing access demonstrates that LECs remain *de facto* monopolists."[22]

[22] MCI Comments at 64. MCI distinguishes between events that might give "the perception of competition" (e.g., FCC-mandated interconnection and collocation, market tests for delivery of telecommunications services over cable television facilities, and even MCI's own announcement that it will become a provider of local services) and the actual *existence* of effective competition.

The Ad Hoc Committee points out that the recent developments in the telecommunications industry "have certainly increased prospects for competition, but their actual economic impact on the local exchange monopolies is, at the present time, minimal."[23] If these large customers see competition as a fledgling phenomenon at best, it goes without saying that smaller customers see the benefits of effective competition as even farther out on the horizon. Consider the comments of the Pennsylvania Consumer Advocate: "PaOCA emphasizes one point above all others. For many of the services provided by the LECs throughout the greatest portion of their services territories, the LEC's [sic] retain monopoly power as the primary if not the sole provider of these services."[24]

IV. The criteria used to assess whether reduced or streamlined regulation should take effect for price cap LECs should be based upon structural measures of market power.

Time Warner's Initial Comments stressed the importance of relying on *structural* measures for determining effective competition such as those identified in the Commission's NPRM as criteria nos. 1, 5, and 7. Such measures include the actual competition in geographical markets, market share, interconnection in LEC central offices and barriers to entry.[25] In addition to the structural measures identified by the NPRM, Time Warner's Initial Comments identified a number of other meaningful criteria for purposes of assessing the point at which reduced or streamlined regulation for price cap LECs should take effect. These additional criteria included functional equivalency of competitive offerings, the substitutability of competitive offerings in the presence of multiple competing suppliers, and

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[23] Ad Hoc Committee Comments, Appendix at 100.

[24] Pennsylvania Office of Consumer Advocate Comments at 3.

[25] Time Warner Initial Comments at 13, citing *NPRM*, para. 95.

the requirement that the service not be an essential or bottleneck service.[26] These quantitative, structural measures for determining market power for price cap LECs must be distinguished from other, unreliable measures that could be satisfied by vague, qualitative, or anecdotal showings of potential competition, the mere existence of competitors, or a perceived willingness of customers to use competitors' services.[27]

The structural measures recommended by Time Warner are consistent with a concept that lies at the heart of mainstream industrial organization (IO) theory and is commonly referred to in the economics literature as the *structure-conduct-performance (S-C-P) paradigm.*[28] The S-C-P paradigm provides a concrete framework for market analysis and is one that enjoys a long history and wide acceptance in the economics literature and in the antitrust courts.[29] In addition, the S-C-P paradigm provides specific analytic techniques for evaluating market power. These techniques involve the measurement of underlying structural conditions in the market as well as observed conduct of firms in the market. In particular, under the S-C-P paradigm, there is an empirical (and causal) relationship between observations about the structure[30] and conduct[31] of an industry on the one hand, and

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[26] *Id.* at 13-15.

[27] *Id.* at 13.

[28] *See, e.g.*, F.M. Scherer and David Ross, *Industrial Market Structure and Economic Performance*, 3d ed. (Boston, Houghton Mifflin Company 1990), Chapter 1.

[29] *Id.*, pp. 4-5. As noted by Scherer, the paradigm has its origins during the 1930s in work by Edward S. Mason of Harvard. Mason's seminal works are "Price and Production Policies of Large-Scale Enterprise," *American Economic Review*, vol. 29 (March 1939), pp. 61-74; and "The Current State of the Monopoly Problem in the United States," *Harvard Law Review*, vol. 62 (June 1949), pp. 1265-1285.

[30] By "structure," we refer to such intrinsic features of the market as the number and size distribution of buyers and sellers, product differentiation, the presence or absence of barriers to entry, underlying cost characteristics of the market, vertical integration, and conglomerateness.

measures of performance[32] on the other, i.e., ultimate market performance can be predicted from observations of conduct which in turn reflect the underlying structure of the relevant market. In general, greater market power yields less desirable economic perfomance in the relevant market.

By contrast, USTA's proposed criteria for assessing whether reduced regulation should apply to price cap LECs are based upon a concept referred to as "addressability" — a theory that is neither established nor supported in the economics or antitrust literature as an appropriate means of measuring market power. Rather, addressability appears to be a *sui generis* standard concocted by price cap LECs to permit the premature deregulation they so fervently seek and that widely accepted measures of market power would not allow.

Under the USTA proposal, the determination of whether a LEC possesses market power would be based upon the proportion of access demand in a market area that is "addressable" by alternative providers, or "where LEC competitors have facilities that can provide service to a customer upon request."[33] USTA asserts that addressability is superior to any of the alternative measures of market power that, it claims, have been proposed by

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See Scherer, *supra.*

[31] "Conduct" refers to strategic policies and behavior of firms in a given market, including such factors as pricing policy, product strategy and advertising, production policies, research and innovation, coercion, legal tactics, and plant investment. *See* Scherer, *supra.*

[32] "Performance" concerns such elements as allocative and technical (least cost) efficiency, progressiveness, full employment, inflation, quality of product, and equity. The performance attributes associated with a market in which one or more firms exercise market power include higher prices, lower output, and a redistribution of wealth from customers to suppliers. *See* Scherer, *supra.*

[33] USTA Comments at x.

other parties, including contestability, supply capacity, and market share.[34] The analysis by which USTA reaches this conclusion is without critical merit.

First, as is discussed in greater detail below, USTA sets a very low standard of comparison when it matches addressability against the largly discredited theory of contestability[35] or with a criterion based strictly upon raw capacity of competitors. Addressability is only slightly better than either of these extremely weak tests. The criticisms of market share also miss the mark by failing to recognize that market share is only one component — albeit an important one — of the criteria supported by the S-C-P paradigm, which is identified in the Commission's *NPRM* and endorsed in the comments of various parties, including Time Warner, as comprehensive approach for assessing LEC market power. In essence, USTA creates a "straw man" paradigm of "market share only" against which to compare its bogus theory of addressability[36] — when in reality, no party

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[34] USTA at 59.

[35] *See, e.g.*, "Contestability vs. Competition," by William G. Shepherd, *The American Economic Review*, Vol. 74, No. 4, September 1984, and "Potential Competition Versus Actual Competition," by William G. Shepherd, *Administrative Law Review*, Vol. 42, Winter 1990.

[36] See, for example, USTA's Position Paper on "Competitive Market Area Demonstration and Data Reporting Requirements, where USTA writes:

> USTA believes that addressability -- rather than market share -- should serve as the keystone of any such mechanism [to measure the extent to which customers in a particular market have access to competitive alternatives].

USTA Comments, Attachment 9, p.1.

See also the paper entitled "Benefits of LEC Price Cap Reform," prepared by USTA expert, Dr. Robert Harris, in which he writes:

> In assessing the degree of competition in a market area, the Commission should not use market share as a measure of market power.

has proposed that the Commission rely upon market share *alone*. Nonetheless, as discussed further below, it would be wholly inconsistent with highly accepted economic and antitrust literature, as well as existing public policy applications, for the Commission to ignore market share entirely, as USTA so desperately attempts to persuade the Commission to do in its assessment of LEC market power.[37]

A. USTA's theory of "Addressability" suffers from the same basic flaws as "Contestability" theory as a standard for assessing LEC market power.

As proposed by USTA, a wire center or group of wire centers within an "Initial Market Area" ("IMA") could be reclassified as a "Transitional Market Area" ("TMA") and thereby become subject to less regulatory scrutiny "based upon the presence of substitutable access services from another source as determined from information filed with the Commission."[38] According to USTA, this criterion could be satisfied by a demonstration of (1) the existence of an operational expanded interconnection arrangement within the wire center, *or* (2) the offering of a substitutable access service by a CAP, IXC, cable television operator, cellular or PSC provider, private carrier, microwave carrier or other entity within the geographic area served by the wire center.[39]

Notwithstanding the requirement for a "physical presence" of alternative suppliers, addressability, like contestability, does not evaluate the *actual ability* of those alternative suppliers to provide effective competition to (i.e., constrain the market power of) the

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USTA Comments, Attachment 2, p. 29.

[37] As discussed in footnote 54, *infra.*, USTA misrepresents the economics literature on market power so as to de-emphasize the relevance of market share.

[38] USTA at 64-65.

[39] *Id.* at 65.

incumbent LEC. Indeed, as evident from criteria (1) and (2) above, addressability could be satisfied by the *mere existence* of an interconnection arrangement, without consideration of the actual effect that such interconnection has had on the access market,[40] or by the *mere existence* of a single competitor, *without consideration of* whether such alternative supplier is actually providing access service in the wire center. The proposed criteria also ignore the countervailing effect on competition of the LEC's excess capacity in the wire center.

The criteria proposed by USTA to reclassify a Transitional Market Area ("TMA") to a "Competitive Market Area" ("CMA") and thereby to be subject to even more relaxed regulation, are similarly flawed. According to USTA, a TMA may be reclassified as a CMA if (1) "customers within the serving area of the wire center representing at least 25 percent of the demand for the local exchange carrier's interstate access services, or 20 percent of the total market demand of interstate access services within that area, have available to them an alternative source of supply",[41] (2) these customers, or a single customer whose demand represents at least 15% of that total, "actively seek to reduce the cost of their access services through the solicitation of bids, use of private networks, or construction of their own facilities."[42]

As with the criteria for classifying wire centers as TMAs, all that appears to be required under criterion (1) to reclassify a wire center as a CMA is that a *single alternative*

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[40] Moreover, given the D.C. Circuit's recent remand of the Commission's collocation policies, *Bell Atlantic Telephone Companies et al. v. FCC, supra*, quantitative market validation of the effects of co-location is unlikely to be available for some time to come.

[41] Setting this test in the alternative adds needless complexity and a level of confusion regarding the actual market share at which the LEC's market area would be reclassified. It also appears that the LEC could satisfy the first of the two alternative criteria while competitors' share of total market demand was still *considerably less* than 20%

[42] USTA Comments at 65.

supplier be physically present in the wire center. Consequently, as a measure of market power, this first criterion suffers from the same shortcomings discussed above with regard to the TMA classification criteria. However, USTA would make it *even easier* to reclassify a market area as competitive. In the Position Paper provided by USTA as Attachment 9 to its Comments (to which the reader is referred "for a more detailed discussion of the concepts and proposals" set forth in its Comments) USTA reveals the LECs plan to use wire center land area "as a surrogate for demand." According to USTA:

> In the future, the demonstration that a sufficient percentage of the customers in a wire center have access to alternative suppliers may require only that the LEC demonstrate the presence of competitive networks serving a substantial proportion of the wire center's land area.[43]

Indeed, USTA goes so far as to actually identify a separate criterion for reclassifying a TMA to a CMA that is based upon land area: if 25% of the land area of the wire center is addressable by competitive networks, then, according to USTA, that wire center could be reclassified as a CMA.[44] Lest it be unclear, USTA spells out exactly what it has in mind, under this "surrogate" criterion, as constituting sufficient evidence of a competitive market for local exchange services in the wire center:

> In the event the Cable TV franchise holds itself ready to offer local exchange service to all customers within its serving area, it should be sufficient for the LEC to demonstrate that a competitive alternative local exchange service is available in 25% of the land area encompassed in the wire center.[45]

Thus, it appears that a mere announcement by a local cable company that it plans to offer local exchange access service in its serving area would be sufficient, in USTA's view, to

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[43] USTA Position Paper, "Competitive Market Area Demonstration and Data Reporting Requirements," p. 23.

[44] *Id.* at 25.

[45] *Id.* at 23.

justify minimal regulation for a LEC in the wire centers in which that cable TV franchise offered service, even before the first customer signs on. This "surrogate" criterion highlights the fact that addressability suffers from the same basic flaw as contestability as a standard for measuring LEC market power — an overemphasis on the mere existence of competition and an underemphasis on the LEC's market power, i.e., ability to price above cost and thereby strategically price services it considers to be potentially competitive so as to deter entry. This highlights the fact that the addressability "standard" as a measure of market power would allow a LEC to "respond" to competition before that competition is capable of providing a constraint on the LEC's market power, thus substantially thwarting the development of effective local exchange competition.

USTA's Criterion (2) for CMA classification, i.e., that customers representing 25% of demand in a wire center or one customer representing 15% of demand actively seeks to reduce the costs of access services, is likewise useless as a means for determining LEC market power. First, to say that a single large customer who "actively seeks to reduce the costs of its access services" somehow demonstrates the LEC's absence of market power in the wire centers serving that customer is nothing short of preposterous. This condition — a large customer seeking to lower its costs for access services — has been in existence since access charges were first implemented. It is natural that large entities — whether they be telecommunications carriers, private enterprise, governmental, or educational institutions — would actively seek to reduce the costs of all aspects of their operations, including the costs of telecommunications access services. Moreover, the "evidence" to demonstrate this second criterion would apparently consist of affidavits from customers (or other "similar evidence"), customer requests for proposals, and customer surveys.[46] These types of "evidence" are

[46] USTA Position Paper at 20, fn. 23; also p. 25, fn. 30.

inherently unreliable, difficult to measure, easily manipulated, and would rely on vague, qualitative, or anecdotal showings of potential competition, the mere existence of competitors, or the perceived willingness of customers to use competitors' services.[47]

B. Addressability is neither established nor supported in the economics or antitrust literature as an appropriate means of measuring LEC market power.

USTA provides a number of documents which address USTA's novel standard of "addressability" for measuring LEC market power. These include the "Economic Benefits of LEC Price Cap Reform," by Robert G. Harris (Attachment 2), "Comments on the USTA Pricing Flexibility Proposal." by Richard Schmalensee and William Taylor (Attachment 4), and the USTA Position Paper "Competitive Market Area Demonstration and Data Reporting Requirements" (Attachment 9). All three of these documents are notable in their absence of citations to the economics or antitrust literature in support of USTA's concept of addressability.

For example, Dr. Harris' paper boldly asserts that "[t]he 'addressability' measure proposed by USTA is a much better indicator of the transition to competition" than market share.[48] Yet, there are no citations to the economics or antitrust literature to support his reliance on addressability as a measure of LEC market power. Nor does Dr. Harris address any structural measures of market power other than market share, such as those identified in Time Warner's initial comments.[49] While potential competition, and more specifically, the

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[47] See Time Warner Comments at 13.

[48] Harris, pp. 29-30.

[49] As noted above, some of the other measures identified in Time Warner's initial comments include the functional equivalency of competitive offerings, the substitutability of competitive offerings in the presence of multiple competing suppliers, and the requirement that the service

ease with which competitors can enter the market, is one factor to consider, Dr. Harris ignores the huge body of industrial organization economics literature that establishes the importance of market share and other structural measures of market power.[50]

Drs. Schmalensee and Taylor assert at the outset of their paper that "Economic theory, the Department of Justice (DOJ) Merger Guidelines, and the Cable Act of 1992 all suggest the form of the USTA proposed standard for competitiveness is appropriate and realistic."[51] However, a reading of the sections of their paper addressing what economic theory, the DOJ Guidelines, and the Cable Act of 1992 actually have to say concerning market power, if anything, provides more support for reliance on structural measures of market power than they do for USTA's concept of addressability.[52]

For example, Schmalensee and Taylor, citing economics literature, explain that "the factor that determines whether or not a price increase is profitable is the price elasticity of demand facing the LEC, and this factor combines elements of market share, the supply reaction of current and potential entrants, and the market price elasticity of demand.[53] The structural criteria identified in Time Warner's initial comments are totally consistent with these factors Schmalensee and Taylor cite from the economics literature, and, significantly,

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not be an essential or bottleneck service.

[50] *See* Scherer *op cit.*; Mason, *supra*; Joe S. Bain, *Industrial Organization* (New York: Wiley, 1959); William M. Landes and Richard A Posner, "Market Power in Antitrust Cases," *Harvard Law Review*, Vol. 94 (March 1981), 937-996. For a survey of the market structure literature relevant to the formulation of competitive criteria in a regulatory environment, *See also* "Market Structure Criteria to Evaluate Lessening Telecommunications Regulation," prepared by Carl E. Hunt, Jr. for the National Association of Regulatory Utility Commissioners, March 20, 1987.

[51] Schmalensee and Taylor, p. iii.

[52] *See* Schmalensee and Taylor, pp. 32-39.

[53] *Id.* at 33.